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INDEX

	Page
CITATION OF CASE IN LOWER COURTS	1
JURISDICTION	1
QUESTION PRESENTED	1, 2
STATEMENT OF THE CASE	2, 3
CERTIFICATION OF ERROR	3, 4
ARGUMENT	
1. Intention of Congress	4, 5, 6, 7, 8, 9, 10, 11, 12
2. Prior Cases Treating this Question	12, 13, 14, 15
APPENDIX	16, 17

TABLE OF CASES AND STATUTES

Cases: *Page*

Arthur E. Braun, Trustee, 29 B. T. A. 1161 7

J. Garfield Buell v. Commissioner, 106 Fed. (2) 398 7

Merrit J. Corbett v. Commissioner, 15 B. T. A. 698 5

Fairbanks v. United States, 306 U. S. 436, (59 Sup. Ct. 607) 6, 7

Helvering v. Hallock, 309 U. S. 106, 60 Sup. Ct. 444, 84 L. Ed. advop. 382 15

Huntting v. Commissioner, 32 B. T. A. 495 5

McClain v. Commissioner, 110 Fed. (2) 878 1

Nichols v. Cooledge, 274 U. S. 531, 47 Sup. Ct. 710 15

Pacific Novelty Co. v. Commissioner, 5 B. T. A. 1017 5

Paul and Mertens Law of Income Taxation, Par. 28.87 4

Stewart v. United States, 106 Fed. (2) 405 11

James Sweinhart, 29 B. T. A. 1179 5

Thomas v. Perkins, 108 Fed. (2) 87 12

S. C. Thomson v. Commissioner, 108 Fed. (2) 642 ..... 12, 13

John H. Watson v. Commissioner, 27 B. T. A. 463 ..... 5, 6

Henry P. Werner, 15 B. T. A. 482 6

STATUTES:

Revenue Act of 1932 4

Revenue Act of 1934 ..... 11, 12

Section 117 (f) 1, 3, 4, 8, 9, 10, 13, 16

Section 23 (k) 2, 3, 8, 10, 11, 13, 16

Revenue Act of 1938

Section 23 (k) 9

Subsections 2 and 3 ..... 9, 16, 17

Regulation 86,
Article 23 (k) 4 ..... 9, 16

Title 28 U. S. C. A., Section 347
(Judicial Code, Section 240) 1

Supreme Court of the United States

OCTOBER TERM, 1940

DONALD S. McCLAIN, *Appellant*
vs.
COMMISSIONER OF INTERNAL REVENUE, *Appellee*

NO. 55

CITATION OF CASE IN LOWER COURTS

Donald S. McClain vs. Commissioner of Internal Revenue, 110 Fed. (2) 878.

JURISDICTION

The jurisdiction of this honorable court is based upon Section 240 of the Judicial Code as amended by the Acts of February 13, 1925 (Title 28 U.S.C.A. Section 347), certiorari having been granted May 20, 1940.

QUESTION PRESENTED

The sole question here presented is whether bonds of a corporation or a political subdivision of a state are "retired" within the meaning of Section 117 (f), Revenue Act of 1934, when the debtor becomes insolvent and unable to meet its obligations, and the creditor receives a payment on the bonds less than the face value thereof. If a "retirement" is thus affected, the loss is limited by the capital loss provisions of

the Revenue Act; if a "retirement" is not thus effected, the loss suffered is as a bad debt and deductible in full by the creditor, taxpayer, under Section 23 (k) of the Revenue Act of 1934.

STATEMENT OF THE CASE

In 1918 Donald S. McCain received as a gift from his father bonds of the Cameron County Water District (Texas) of the face amount and of the value of $15,000. The Cameron County Water Improvement District was a political subdivision of the State of Texas. (R. pp. 14 and 15.)

In 1935 the said water district became financially embarrassed and was in default on both principal and interest on its outstanding bonds. (Tr. p. 15.) After an unsuccessful attempt at bankruptcy, said attempt being unsuccessful because the Municipal Bankruptcy Act was declared unconstitutional, the water district applied to the Reconstruction Finance Corporation for a loan. In the year 1935 it was successful in securing a loan from that corporation to the extent of $264,500, this being sufficient to pay 49.9 per cent of its outstanding bonds. (R. pp. 15 and 16.) The Reconstruction Finance Corporation, prior to making this loan, had made a survey of the properties of the water district and general conditions and had determined that the loan made was the maximum amount that the water district could stand, and at the same time, meet its current liabilities and charges. (R. p. 17.)

After securing this loan from the Reconstruction Finance Corporation, the Cameron County Water District paid to Donald S. McCain the sum of $7,476.75, which amounted to 49.9 per cent of his bonds. (R. p. 17.) In view of all of the circumstances bearing upon the financial responsibility of the water district and its inability to meet its obligations,

Donald S. McCain accepted this payment and in turn determined the balance of these bonds to be uncollectible in year 1935, and in that year charged off on his books the sum of $7,523.25 as uncollectible, and in his income tax for that year claimed a deduction of that amount, pursuant to the provisions of Section 23 (k) of the Revenue Act of 1934. In other words, he treated the loss suffered by him as a loss upon a debt becoming partially worthless and uncollectible. In fact, the debt became uncollectible during 1935, except to the extent of 49.9 per cent on the dollar. (R. p. 18.)

The understanding of Donald S. McClain in accepting the amount agreed on was that he would receive the payment thereon at the rate of 49.9 per cent and that such payment was to be the only amount he would receive. However, there was no writing to evidence this, nor in fact any agreement between the district and the bondholders to this effect. (R. p. 18.)

The Commissioner in auditing the returns of Mr. McClain disallowed this deduction and assessed a deficiency. The disallowance of the Commissioner was based upon his contention that the bonds had been "retired" within the meaning of Section 117 (f) of the Revenue Act of 1934, and, consequently, that the loss suffered was a capital loss limited to $2,000.

CERTIFICATION OF ERROR

The Circuit Court of Appeals erred:

1. In its ruling that the bonds in question were retired within the meaning of Section 117 (f) of the Revenue Act of 1934.

2. In its ruling that the bonds were retired and in ruling that petitioner was not entitled to deduct the loss suffered as for a bad debt.

3. In affirming the decision of the United States Board of Tax Appeals.

ARGUMENT

I. INTENTION OF CONGRESS

Did Congress intend the word "retirement," as used in Section 117 (f) to include the situation where an insolvent debtor pays a portion only of its obligations? To determine the intention of Congress, appellant feels it important to trace the history of this section from the Revenue Act of 1932 to date.

The Revenue Act of 1932 did not include Section 117 (f) and it was held under the provision of that Act that bonds becoming worthless could be charged off as a bad debt in the full amount.

Paul and Mertens Law of Income Taxation, par. 28.87.

> "Bonds Which Have Become Worthless. There has been conflict as to whether worthless bonds could be deducted under the bad debts provision of the statutes. The later decisions generally clarified the situation so that now a deduction for worthless bonds may, if all circumstances warrant it, be taken as a bad debt; the latest decisions are in accord with some earlier decisions which allowed the deduction as bad debts, and with the regulations providing:
>
> "'Where bonds purchased before March 1, 1913, depreciated in value between the date of purchase and that date, and were in a later year ascertained to be worthless and charged off, the owner is entitled to a deduction in that year equal to the cost of the bonds. Bonds purchased since February 28, 1913, when ascertained to be worthless, may be treated as bad debts to the amount

actually paid for them. Bonds of an insolvent corporation secured only by a mortgage from which on foreclosure nothing is realized for the bondholders are regarded as ascertained to be worthless not later than the year of the foreclosure sale, and no deduction for a bad debt is allowable in computing a bondholder's income for a subsequent year. A deduction for a bad debt based upon the value of the debt on March 1, 1913, is allowable only when such value is established to the satisfaction of the Commissioner.'

"The general rules regarding the deduction of worthless bonds are not essentially different from those governing worthless debts generally. The taxpayer who seeks to deduct worthless bonds as bad debts must show that the debt was ascertained to be worthless and charged off. Indebtedness evidenced by bonds may be ascertained to be worthless before the maturity of the bonds. The fact that bonds have been sold at a nominal price does not preclude deductibility."

See also *Merrit J. Corbett v. Commissioner*, 15 B. T. A. 698.

It was also held that bonds which were determined to be partially uncollectible could be charged off as bad debts to the extent of their uncollectibility. *Huntting v. Commissioner*, 32 B. T. A. 495.

It was also held, generally, that amounts lost by the composition with an insolvent debtor could be charged off as a bad debt. *Pacific Novelty Co. v. Commissioner*, 5 B. T. A. 1017. See also *James Sweinhart*, 29 B. T. A. 1179.

It was generally held also that those transactions which amounted to a retirement, that is where bonds were called and paid at par, resulted in an ordinary loss. This was established by the decision of *John H. Watson v. Commissioner*,

27 B. T. A. 463, decided by the Board of Tax Appeals, on December 29, 1932. (The ruling in this case was specifically approved by this court in *Fairbanks v. U. S.*, 306 U. S. 436, 59 Sup. Ct. 607.) This reversed the case of *Henry P. Werner*, 15 B. T. A. 482, wherein it had been held that the retirement of bonds by the payment therefor at maturity resulted in the capital gain or loss as the case might be. The Watson case has been followed consistently by the Board since 1932. John H. Watson, supra, at page 465:

> "On further consideration we are of the opinion that the Board erred in its holding in Henry P. Werner, supra. It is elemental that where a statute is clear and unambiguous in its terms and provisions resort should not be had to legislative history to determine the limits of its compass. The statute in question is so simple in construction and so clear in meaning that it justifies no resort to the Congressional Committee's report as an aid in the interpretation thereof.
>
> "The words 'sale or exchange' are ordinary words of well established meaning. Taken in their context they are susceptible of no misconstruction. Payment of the amounts specified in the bonds, either at maturity or pursuant to an authorized call prior to maturity, is not a 'sale or exchange' of such bonds. It is merely the payment of an obligation according to its fixed terms. For these reasons we believe the decision in Henry P. Werner, supra, was erroneous and it is accordingly overruled.
>
> "In the instant case there was neither a 'sale' nor an 'exchange' of a capital asset when the Liberty bonds were paid at maturity. There was the satisfaction of an obligation of the United States by payment. Loss incurred or gain realized in such a transaction is not a capital loss or a capital gain under the definition found in the statute.

"Following the same thought further we are of the opinion that I. T. 1637 correctly interpreted Section 206 of the Revenue Act of 1921 and corresponding provisions of the later acts and that I. T. 2488, which went even further than the Werner case, is an erroneous interpretation."

Arthur E. Braun, Trustee, 29 B. T. A. 1161, at page 1177:

"Petitioner's contention on this point must be sustained. The Revenue Act of 1926 (Sec. 208(a)) defines 'capital gain' as meaning taxable gain from the sale or exchange of capital assets consummated after December 31, 1921. The bonds in question were capital assets, but they were not sold or exchanged. Payment of the amount specified in a bond, either at maturity or pursuant to an authorized call prior to maturity, is not a sale or exchange of such bond, and the gain derived from the transaction is taxable as ordinary income. John H. Watson, Jr., 27 B. T. A. 463. The deficiency for 1927 will be redetermined accordingly."

To the same effect see:

J. Garfield Buell v. Commissioner, 106 Fed. (2d) 398.
Fairbanks v. United States, 306 U. S. 436, 59 Sup. Ct. 607.

It is evident from the authorities set out above that had the transaction here involved taken place prior to the enactment of the Revenue Act of 1934 that the loss suffered would have been properly treated as a bad debt loss, and so treated by the Commissioner of Internal Revenue.

The question remains to be determined whether the Revenue Act of 1934 altered the situation with regard to the partial payment of the principal of bonds by an insolvent debtor.

If this charge in the prior law was affected by the Revenue Act of 1934, it must have been affected by Section 117. (f) which provides "Amounts received by the holder upon the retirement of bonds, debentures, notes, certificates or other evidences of indebtedness issued by any corporation (including those issued by a government or political subdivision thereof) with interest coupons or in registered form, shall be considered as amounts received in exchange therefor."

It would appear that Section 117 (f) was aimed directly at the situation presented by the *John F. Watson* case. It must be borne in mind that the Watson case was decided on December 29, 1932, after the enactment of the Revenue Act of 1932, which was enacted on June 6, 1932. Congress did not have an opportunity to alter the law with regard to the *John F. Watson* case until the enactment of the Revenue Act of 1934. It has been decided too many times to warrant citations of cases that words in the Revenue Act are taken in their usual sense. Hence the word "retirement" must be used in its ordinary sense. The word "retirement" as used in connection with corporate financing means the *payment* of any corporate obligation in full at maturity. It does not have reference to the compromising of corporate obligations or an incomplete or partial payment thereof.

Indeed, had Congress intended to direct the Revenue Act of 1934 to the situation presented by this appeal, it could have easily done so by amending Section 23 (k). The intention not to alter the situation presented by the compromise of a debt by an insolvent debtor is quite apparent from the fact that Section 23 (k) was not amended. It is submitted that the amendment to Section 117, as above set out, was adopted purely and simply to cure the situation which had arisen from the *John F. Watson* case. The Commissioner's regulations

with regard to bad debts remained unchanged after Section 117 (f) was enacted.

REGULATION 86

"Art. 23 (k)-4. Worthless bonds and similar obligations.—Bonds, if ascertained to be worthless, may be treated as bad debts to the amount actually paid for them. Bonds of an insolvent corporation secured only by a mortgage from which on foreclosure nothing is realized for the bondholders are regarded as ascertained to be worthless not later than the year of the foreclosure sale, and no deduction for a bad debt is allowable in computing a bondholder's income for subsequent year."

The fact that the intention of Congress was directed purely and simply to the retiring of bonds at the face amount upon maturity is further demonstrated by the amendments to the law in the Revenue Act of 1938. In this Revenue Act, Section 23 (k) was amended to take care of situations similar to those presented here. There was added to Section 23 (k), sub-section 2, which reads as follows:

"SECURITIES BECOMING WORTHLESS.—If any securities (as defined in paragraph (3) of this sub-section) are ascertained to be worthless and charged off within the taxable year and are capital assets, the loss resulting therefrom shall, in the case of a taxpayer other than a bank, as defined in Section 104, for the purposes of this title, be considered *as a loss from the sale or exchange*, on the last day of such taxable year, of capital assets." (Italics ours.)

As further showing the intent of Congress on this same point, reference is made to the House Committee on Ways and Means Report in regard to the Revenue Act of 1938, at page 18:

"Under Section 23 (e) of the Revenue Act of 1936 a loss sustained from securities becoming worthless which

is deductible under that sub-section is deductible in full and against ordinary income. In contrast thereto a loss sustained from the sale or exchange of such securities as are capital assets is not only subject to reduction by the percentage brackets of Section 117 (a) of that Act but cannot be offset against ordinary income except to the extent of $2,000. This distinction in treatment is not satisfactory, since, in either case, the loss sustained by the taxpayer is a loss of capital and consequently should be treated similarly for tax purposes. This difference in treatment is eliminated by the bill. Section 23 (g) thereof, dealing with capital losses, subjects losses arising from stock or stock rights becoming worthless to the same limitations provided under Section 117 of the bill with respect to sales or exchanges.

"A similar difference exists in the treatment of losses sustained when bonds (which are capital assets) become uncollectible and so are deductible as bad debts under Section 23 (k) of the Revenue Act of 1936. This difference in treatment is also eliminated by the bill. Section 23 (k) thereof subjects losses arising from securities, as defined therein, becoming worthless, to the same limitations provided for under Section 117. Securities as defined in Section 23 (k) means bonds, debentures, notes, certificates, or other evidences of corporate indebtedness, with interest coupons or in registered form."

Had Congress intended by implication to amend Section 23 (k) of that Revenue Act in 1934, then it would not have been necessary in 1938, to amend that section, as was in fact done. *Fairbanks vs. U. S.*, supra. The very fact that Congress in a Revenue Act deals with a specific situation, indicates clearly that it intends to alter the law as it stood before such enactment. In other words, if it had been understood by Congress that Section 23 (k) of the Revenue Act of 1934 was, by implication, amended by the addition of Section 117 (f) to

that Revenue Act, then, indeed, the action of Congress in 1938 in specifically amending Section 23 (k) was merely an idle gesture. It cannot be thought that Congress would by specific amendment deal with a situation in exactly the same manner as Congress had intended that situation to be handled in prior legislation. The very fact of a change in 1938 indicates that Congress did not intend to amend Section 23 (k) in 1934. *Stewart v. United States*, 106 Fed. (2) 405, headnote 8:

> "Moreover, we have the Congress, by Section 817 of the Revenue Act of 1938, 52 Stat. 447, 578, 12 U. S. C. A. 1931a, expressly repealing or amending Section 26 of the Farm Loan Act by declaring 'all income, except interest, derived' from such bonds, shall be included in gross income. If such income was taxable despite Section 26 prior to the Revenue Act of 1938, what was the reason for Section 817 of the latter act? The answer is obvious—under the statutes that income was theretofore exempt. Cf. Brewster v. Gage, 280 U. S. 327, 337, 50 S. Ct. 115, 74 L. Ed. 457. In this Section 817 the Congress said what it could have said in 1916 or in 1928, or any year, but did not. The enactment of the act in 1938 was no idle gesture but was necessary to change the proper construction of the law as it stood prior thereto. 'This was the explicit and intelligible declaration to which the public was entitled * * *.' when the Congress decided to terminate the exemption theretofore granted. State of South Carolina ex rel. Wagner v. Stoll, 84 U. S. 425, 436, 17 Wall. 425, 21 L. Ed. 650. This was the specific amendment or repeal of Section 26 and the attempt to argue that the same result had already been accomplished by the Revenue Act of 1928 is futile."
> *Fairbanks v. United States, supra.*

It cannot be doubted that Congress intended by the Revenue Act of 1934 to deal exclusively with *retirement* of bonds, in the legal sense, and that it did not have in mind bonds be-

coming totally or partially uncollectible. This being true, the determination of the question here rests squarely upon the simple question of whether the meaning of the word "retirement" in the Revenue Act of 1934 can be stretched and distorted to include situations where a debtor becomes insolvent and its bondholders realizing that the full amount of the debt can never be paid receive payment of a part only of the face amount of the obligation.

II. PRIOR CASES TREATING THIS QUESTION

The only courts which have passed on this exact question are the Circuit Courts of Appeal for the Fifth and Eighth Circuits. The Fifth Circuit has had before it, in addition to the present case, the case of *Thomas v. Perkins*, 108 Fed. (2) 87. The Eighth Circuit has ruled on this question in the case of *S. C. Thomson v. Commissioner*, 108 Fed. (2) 642, which case is also before this court on certiorari.

The Fifth Circuit has not been consistent in its opinions for in the Thomas case when this question was presented, the result reached was exactly opposite to that reached in the present case.

Thomas v. Perkins, 108 Fed. (2) 87.

This was an action by Perkins and wife to recover income taxes allegedly illegally collected in the year 1935. Mr. Perkins had purchased Class B certificates of the Creditors' Committee of American Refining Company, Inc., at a cost of $185,333.05. When all the assets of the insolvent were liquidated by the committee, it paid to Mr. Perkins $32,283. He claimed a bad debt loss for the year 1935 of $153,030.15, being the difference between the amount paid and the amount

received. This claim was predicated upon Section 23 (k) of the Revenue Act of 1934.

The Commissioner of Internal Revenue disallowed the loss except for $2,000. One of the alternate theories for thus limiting the loss was that the certificates had been retired within the meaning of Section 117 (f) of the Revenue Act of 1934.

The Circuit Court in passing on this contention dismissed it with the following statement: Quoting from page 89:

> "Agreeing with appellee that the point is without merit, that no sort of strained construction of the invoked section will permit its application to appellee's certificates, and the payments on them, we pass to a consideration of the appellant's main point. * * *."

This ruling embraces the correct interpretation of Section 117 (f) as demonstrated in the first part of this brief.

In deciding the present case, the Circuit Court for the Fifth Circuit did not even mention the Thomas case, although it was called to the court's attention and thoroughly discussed in the brief and argument.

Since the *S. C. Thomson* (supra) case is now before this court it needs no discussion here. The case was correctly decided below and should be affirmed. The following quotation from that case aptly states the correct rule of law. Quoting from 108 Fed. (2), at page 643:

> "We are of opinion that what happened here may not fairly be taken as a 'retirement' of the petitioner's debentures. Dictionary definitions of 'retire' are 'to pay up and withdraw from circulation,' 'to withdraw from circulation or from the market,' 'to take up or pay.' The word signifies some voluntary action on the debtor's

part *in fulfillment of his promise to pay*. A man as sanguine as Micawber might describe his bankruptcy as a 'retirement' of his obligations, but a merchant seeking credit who spoke in such euphemisms might find himself in trouble later. Where creditors receive a petty dividend (one-half of one per cent in this case) on the collapse of their debtor, their claims may be extinguished but are hardly 'retired.' The Board was in error in treating the case as one of 'retirement' of the petitioner's debentures."

Although counsel in the Thomson case, in their brief in opposition to certiorari sought to distinguish the "McClain" case, no such distinction is tenable.

Insolvency of the debtor exists in both cases. Partial worthlessness of the obligation exists in both cases. An actual pecuniary loss exists in both cases. The facts of the two cases are identical except for the fact that a receiver was appointed for the debtor in the Thomson case, and the assets were liquidated and distributed through the receivership.

In the case of Mr. McClain, his debtor attempted bankruptcy and failed. The fact of attempted bankruptcy plus the findings of the Reconstruction Finance Corporation conclusively demonstrated insolvency at the time this transaction took place. Mr. McClain had two alternatives in the matter: (a) recognize the impossibility of the situation and salvage what he could, or (b) institute expensive litigation to foreclose and spend his remaining value in attorneys' fees and court costs. The practical result in both cases would have been the same, except in the amount ultimately received. Being practical and sensible, the alternative was adopted which would salvage the most from the wreckage.

This court has consistently and frequently announced that taxation is a practical problem to be approached in a prac-

tical manner and legal casuitries and intricacies to be avoided. Practically approached the Thomas, Thomson and McClain cases present the same questions.

> "Taxes are very real things and statutes imposing them are estimated by practical results."

Nichols vs. Coolidge, 274 U. S. 531 at 541; 47 Sup. Ct. 710. Cf. *Helvering v. Hallock*, 309 U. S. 106, 60 S. Ct. 444, 84 L. Ed. advop. 382.

Respectfully submitted,

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APPENDIX

Section 23 (k) of the Revenue Act of 1934:

"Bad debts.—Debts ascertained to be worthless and charged off within the taxable year (or, in the discretion of the Commissioner, a reasonable addition to a reserve for bad debts); and when satisfied that a debt is recoverable only in part, the Commissioner may allow such debt, in an amount not in excess of the part charged off within the taxable year, as a deduction."

Section 117 (f) of the Revenue Act of 1934:

"Retirement of bonds, etc.—For the purposes of this title, amounts received by the holder upon the retirement of bonds, debentures, notes, or certificates or other evidences of indebtedness issued by any corporation (including those issued by a government or political subdivision thereof), with interest coupons or in registered form, shall be considered as amounts received in exchange therefor."

Regulation 86, Article 23 (k) 4, Revenue Act of 1934:

"Worthless bonds and similar obligations.—Bonds, if ascertained to be worthless, may be treated as bad debts to the amount actually paid for them. Bonds of an insolvent corporation secured only by a mortgage from which on foreclosure nothing is realized for the bondholders are regarded as ascertained to be worthless not later than the year of the foreclosure sale, and no deduction for a bad debt is allowable in computing a bondholder's income for a subsequent year."

Section 23 (k) (2) and (3) of the Revenue Act of 1938:

"Securities Becoming Worthless.—If any securities (as defined in paragraph (3) of this subsection) are ascertained to be worthless and charged off within the taxable year and are captal assets, the loss resulting therefrom shall, in the case of a taxpayer other than a bank, as defined in section 104, for the purposes of this title, be considered as a loss from the sale or exchange, on the last day of such taxable year, as capital assets.

"Definition of Securities.—As used in this subsection the term 'securities' means bonds, debentures, notes, or certificates, or other evidences of indebtedness, issued by any corporation (including those issued by a government or political subdivision thereof), with interest coupons or in registered form."